Economic Outlook

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Recently released economic indicators are painting two very different pictures of the economy. Sales and new orders plunged in January, but employment and production continued to post strong gains. One has to wonder which set of data more adequately reflects the underlying economic conditions. The declines in sales and new orders in January were heavily influenced by tax reform. Consumers rushed their purchases of big ticket items and many businesses timed their purchases of equipment toward the end of 1986 while they could still qualify for more lucrative tax benefits under the old tax law. As a result, would-be January sales were moved into late 1986, and sales subsequently plummeted in January. A better reading of the underlying tone of the economy could probably be obtained by averaging the January and December data. For example, in the two-month period of January and December, both retail sales and factory orders were 1.3% higher than in the previous two months. This suggests that the sharp declines in sales and orders in January were simply reactions to the December aberration rather than a reflection of fundamental economic weakness. The strong gains in employment and the recovery of auto sales in February provide further evidence of a relatively robust economy.

As the increases in production are likely to outpace the increases in sales this quarter, a large inventory accumulation is expected. With inventory/sales ratios extremely low in most industries at the end of 1986, businesses will likely see this buildup as desirable, and production cutbacks should not result. Due in large part to this inventory buildup, real GNP growth is expected to be 3% or better in the current quarter. The increase in final sales, however, is likely to be disappointing.

Will a small increase or even a decline in final sales this quarter pave the way for sluggish growth in the second quarter? This is what happened last year, when the first quarter's strong growth of 3.8% was followed by the second quarter's weak growth of 0.6%. A repeat of this growth pattern, however, is unlikely this year. The sluggishness in the second quarter of 1986 was caused by a significant slowdown in inventory investment and a sharp deterioration in net exports. As the expected inventory buildup in the current quarter would still leave inventory/sales ratios at relatively comfortable levels, only a moderate slowdown in inventory accumulation is expected in this year's second quarter. Net exports are expected to continue to strengthen throughout this year. As a result, in spite of a large inventory buildup in the current quarter, no slowdown in economic growth in the second quarter is expected.

For the last two years, a sluggish industrial sector has been a major drag on overall growth. From the fourth quarter of 1984 to the fourth quarter of 1986, industrial production increased at an annual rate of only 1.4%, compared to real GNP growth of 2.5%. Foreign competition was often cited as the main factor behind the industrial malaise. A much lower dollar has now significantly improved the competitiveness of the U.S. industrial sector. In the fourth quarter of 1986, trade-related improvements boosted industrial production growth to an annualized rate of 3%, the strongest performance since mid-1984. Continuing to benefit from the more favorable competitive position, the industrial sector is likely to grow faster than the overall economy this year.

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Economic Forecast

Percent Changes at Annual Rates

	Actual 1986				Forecast 1987				Actual	Forecast
	I	II	III	IV	I	II	III	IV	1984-1985	1985-1986	1986-1987
Gross National Product	6.2	2.6	6.4	1.9	7.2	7.2	8.5	7.8	6.2	5.2	6.0
Real GNP	3.8	0.6	2.8	1.3	3.1	3.5	4.1	3.3	2.7	2.5	2.8
GNP Price Deflator	2.5	1.8	3.6	0.7	4.0	3.6	4.2	4.4	3.3	2.6	3.1

	Actual 1986: IV	Forecast 1987: I	Actual 1984-1985	Actual 1985-1986	Forecast 1986-1987
Consumer Spending	3.3%	3.9%	7.1%	6.3%	6.0%
Durable Goods	-9.5	-16.0	8.5	8.1	1.7
Nondurable Goods	3.0	7.9	4.0	3.0	5.8
Services	7.4	7.3	8.9	7.9	7.3
Business Capital Spending	2.1	0.6	10.0	0.2	2.1
Structures	-7.5	-0.3	11.1	-7.6	-4.1
Equipment	6.5	1.0	9.4	4.2	5.0
Residential Investment	9.3	9.5	5.7	13.1	8.7
			1985	1986	1987
Change in Inventories	$-22.5b.	$24.0b.	$11.1b.	$7.8b.	$24.8b.
Net Exports of Goods and Services	$-113.6b.	$-112.5b.	$-78.9b.	$-105.2b.	$-101.3b.
			1984-1985	1985-1986	1986-1987
Government Purchases	5.8%	-2.7	11.2%	6.0%	4.3%
Federal	5.2	-14.6	13.7	3.5	0.6
Defense	-8.2	4.9	10.4	7.2	4.3
Other	62.8	-57.3	24.3	-6.4	-10.8
State & Local	6.3	6.7	9.3	7.9	7.1
Corporate Profits Before Tax	6.4*F	15.0*	-5.3	5.5	11.1
Corporate Profits After Tax	1.0*F	8.0*	-6.3	1.3	12.3
Plant and Equipment Expenditures	1.8F	1.2	9.2	-2.8F	1.8
Real Final Sales#	4.0	-1.7	4.2	2.6	2.4
Real Disposable Personal Income	-1.4	2.7	2.3	2.9	2.1

Economic Indicators	Recent Data Nov.	Dec.	Jan.	Actual 1984-1985	Actual 1985-1986	Forecast 1986-1987
Consumer Price Index**	2.4%	2.4%	8.4%	3.8%	1.1%	4.7%
Producer Price Index for Finished Goods**	1.2	-1.2	7.2	1.8	-2.5	4.2
Industrial Production	7.2	3.6	4.8	2.2	1.0	3.3
Retail Sales##	-0.5	4.6	-5.8	6.4	5.3	4.5
				1985	1986	1987
Auto Sales (millions of units, a.r.)	10.5	13.6	8.2	11.0	11.5	10.7
Housing Starts (millions of units, a.r.)	1.64	1.81	1.81	1.74	1.81	1.66
Unemployment Rate	6.9%	6.7%	6.7%	7.2%	7.0%	6.5%
Merchandise Trade Deficit (a.r.)	$-230.7b.	$-127.9b.	$-177.4b.	$-148.5b.	$-169.8b.	$-155.0b.

Unless noted otherwise, all data are period-to-period percent changes at annual rates, derived from seasonally adjusted data.

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#GNP less change in inventories, both in real terms.
##Monthly percent changes are not annualized.
*Year-over-year percent changes.
**Annual percent changes are December to December (not seasonally adjusted).

$b. = billions a.r. = annual rate F = Forecast